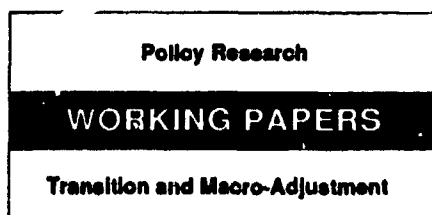


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Corporate Governance in Central and Eastern Europe

Lessons from Advanced Market Economies

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and
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The countries of Central and Eastern Europe need to opt on the side of stronger and more active corporate governance. German and Japanese models may offer some clues.

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Patterns of corporate ownership and governance in advanced market economies vary immensely, the result not only of policy choice but of cultural and political differences and historical accident. None of those patterns can be copied wholesale onto the Central and Eastern European scene. But the experiences of Germany, Japan, and the United States do point to certain lessons and tradeoffs that the Central and Eastern European countries should consider.

First, there is probably some tradeoff between the distribution of wealth and the efficacy of corporate governance in an economy. Theory and to some extent practice support the view that tighter ownership patterns lead to better corporate performance. But more widely dispersed ownership patterns clearly have other economic and social benefits that are important in the Central and Eastern European context and to some extent (along with speed) motivate the "mass privatization" plans. The use of institutional intermediaries and creative legal frameworks to concentrate voice more than ownership may be a partial solution to the dilemma. Stronger and more committed voice might also be gained by encouraging ownership by parties with other long-term contractual interests, whether as suppliers, employees, or creditors.

Second, there is likely to be some tradeoff between industrial structure and the efficacy of corporate governance. Given a certain dispersion of ownership in an economy, smaller firms mean fewer owners, greater stakes per owner, and

greater incentives and lower costs for shareholder monitoring. Yet Central and Eastern European industrial structures tend to be quite highly concentrated. There may be other benefits to preserving such concentration in some industries, but antimonopoly and privatization policies should not leave the governance issue out of the equation.

Finally, there is clearly an important and difficult tradeoff between the efficacy of corporate governance and concerns of safety and soundness in financial intermediaries. The United States represents one extreme, where concerns of safety and soundness dominate, limiting active participation in corporate governance by banks, insurance companies, pension funds, and mutual funds. Germany and Japan are on the other side, allowing financial intermediaries (and other related firms) a major voice in corporate governance. Unfortunately, this tradeoff is even more difficult in Central and Eastern Europe because of the lack of alternative tools to achieve either goal. On the one hand, legal and information systems are relatively weak, making it difficult to identify and eliminate irresponsible self-dealing by fiduciaries in the intermediary institutions. Furthermore, the high degree of risk in these economies argues strongly in favor of diversification on the grounds of safety and soundness. On the other hand, product, capital, and labor markets are often underdeveloped, so there may be few other constraints to discipline company managers in the absence of active shareholder monitoring.

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**CORPORATE GOVERNANCE IN
CENTRAL AND EASTERN EUROPE:
LESSONS FROM ADVANCED MARKET ECONOMIES**

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Corporate Governance in Central and Eastern Europe: Lessons from Advanced Market Economies

The countries of Central and Eastern Europe (CEE) are moving rapidly to privatize state enterprises and remove centralized administrative controls over the economy. This move towards private ownership is based on the underlying proposition that the incentives created by private ownership will lead to a more efficient economy. For this to happen, however, ownership must be coupled with some degree of shareholder control over managerial decision making in a firm. While good corporate governance is a key to the sound functioning of any private market economy, the need for massive enterprise restructuring in reforming socialist economies arguably heightens the importance of effective corporate governance (and may change the nature of governance issues) in those settings.

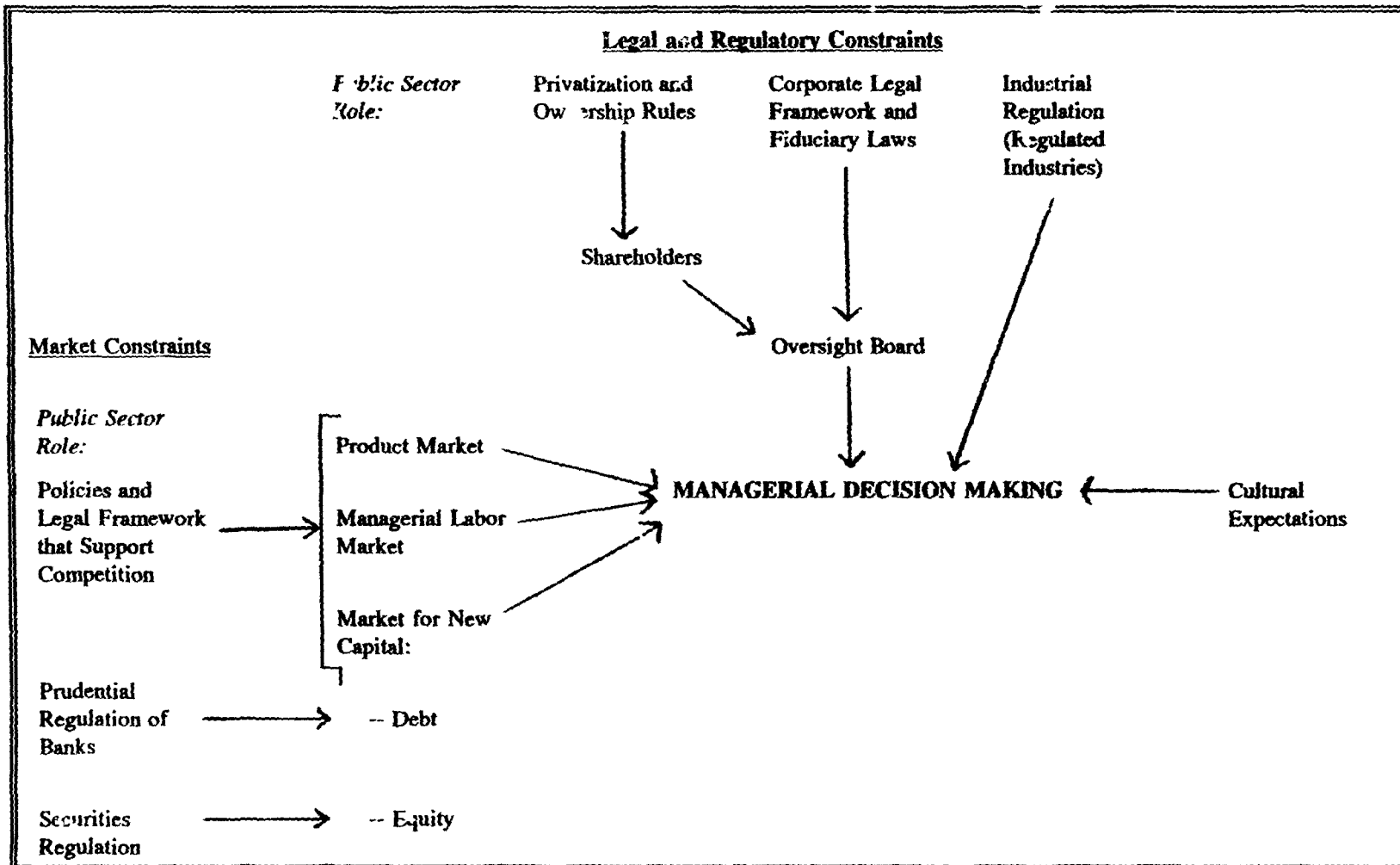
Policy makers and advisors are justifiably giving great attention to techniques of privatization and to details of implementation, but less attention to what happens next. In what legal, economic, and cultural environment will these firms operate? Who will be and/or should be their new owners, managers, and overseers? Is an adequate legal and informational framework in place to promote fiduciary responsibility on the part of such managers and overseers? Even after privatization, governments will continue to play the important role of defining the basic legal framework for private ownership and control.

What is "Corporate Governance"?

Managers in a market economy face a wide array of constraints, both economic and legal, facing managers as they carry out their jobs (Figure 1). On the economic side, product markets and the desire to avoid bankruptcy clearly constrain managerial behavior. Capital markets exert discipline on managers of those firms that must raise money externally. Labor markets constrain managers to the extent their jobs are contestable or they expect to seek other employment in the future. On the legal side, government regulations and laws of fiduciary responsibility can constrain managerial behavior. A further, and very powerful, constraint on managerial behavior is the cultural norm of commercial behavior prevailing in an economy.

The focus of this paper is on the type of constraint on managerial behavior most typically associated with the term "corporate governance": shareholder monitoring. *Although shareholder monitoring is only one of numerous constraints on managerial behavior in advanced market economies, it is likely to be more important in the early stages of reform in CEE economies to the extent that markets for products, capital, and managerial labor are still underdeveloped and thus do not yet exert strong competitive pressures on managers.*

Figure 1: THE MANY CONSTRAINTS ON MANAGERS



Shareholder monitoring can be passive or active. Passive shareholders rely on "exit" as their main discipline on managers, while active shareholders rely more heavily on "voice". The U.S. model, for example, is heavily weighted towards "exit," while the German and Japanese models rely more on "voice."¹ The various systems in advanced market economies each have advantages and disadvantages. Each is in many ways a unique outgrowth of country-specific economic, political, historic, and cultural factors, and it is neither desirable nor possible to "import" an entire model into the CEE context. However, it is possible to isolate certain characteristics of particular systems that might work or not work well in the CEE context, at least in the short- to medium-run. *In Central and Eastern Europe, where stock markets are poorly developed, exit is unlikely to be an efficient option for some time to come, and thus active shareholder monitoring is likely to be one of the most important modes of corporate governance in the near term.*

The legal framework in an economy influences shareholder monitoring in two critical ways, as explored in turn below. First, it governs ownership patterns: who may own companies, how much they may own, and to what extent they can exert an "active" ownership role. Second, it translates this ownership structure into shareholder influence through the definition of share voting rights and duties, share voting rules, and the structure and composition of oversight bodies within the company. Experience in advanced market economies shows that ownership patterns and the legal frameworks in which owners exert control can vary immensely, leading to major differences in models of corporate governance, managerial behavior, and arguably firm performance (although the latter relationship is difficult to prove empirically). In the CEE context, where markets are not in equilibrium and where major improvements in efficiency are likely to depend not so much on marginal changes in managerial behavior as on successful large-scale restructuring at the firm level, alternative patterns of corporate governance should be judged not only on how they affect day-to-day decision making but also on how they affect a firm's capacity for change and restructuring.

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1. It is also interesting to note that the various systems appear to be evolving more toward each other over time, as critics of the U.S. system argue for more voice, while critics of the German and Japanese system argue for more openness, flexibility, and ease of entry and exit. For a strong argument that the U.S. needs more emphasis on "voice" (i.e. more "dedicated capital") and less on "exit," see M.E. Porter, "Capital Choices: Changing the Way America Invests in Industry," Council on Competitiveness and Harvard Business School, June 1992. For an argument that the German and Japanese systems are too protected and tend to entrench management, see J. Abegglen and G. Stalk, Kaisha, the Japanese Corporation, (New York: Basic Books), 1985. For evidence that the two systems are moving closer together, see D. Sharfstein, "Japanese Corporate Finance and Governance: Implications for the Privatization of Eastern European Enterprises," mimeo, January 1992 (which discusses how Japan's deregulation of its corporate bond market in the late 1980s led to a significant weakening in keiretsu ties between banks and those firms strong enough to obtain financing on international bond markets) and J. Pound, "Beyond Takeovers: Politics Comes to Corporate Control," Harvard Business Review, March-April 1992 (which discusses the growing "voice" being exerted by investors in the U.S.).

Ownership Rules and Corporate Governance

Ownership Rules in Advanced Market Economies

Patterns of corporate ownership (Table 1) and models of corporate governance vary widely among advanced market economies. Although cultural characteristics may account for some of this difference, much is due directly to the wide differences in their legal frameworks for company ownership. In the U.S., legal restrictions originally designed to protect investors and depositors and fragment financial power have led to a relatively small role for institutional intermediaries in both ownership and monitoring of large companies.² The Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956 restrict banks from holding direct and active equity interests in companies or affiliating with investment banks, mutual funds, securities businesses, or insurance companies. As a result, banks play virtually no role in company ownership or governance. Other financial institutions--such as insurance companies, pension funds, and mutual funds--play a relatively modest role, in large part due to legal requirements for diversification based on notions of safety and soundness. A variety of state regulations restrict life insurance companies from owning large blocks of individual firms' stock.³ Pension funds are in practice restricted from taking large stakes in firms by the "prudent man" rule of the Employee Retirement Investor Security Act (ERISA). Mutual funds are in essence prevented from buying more than 10 percent of a company's stock (and inhibited from buying more than 5 percent) by regulatory and tax restrictions.⁴ Furthermore, any active shareholder or shareholding group that acquires a 5 percent stake in

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2. See S.D. Prowse, "Institutional Investment Patterns and Corporate Financial Behavior in the U.S. and Japan," *J. Fin. Econ.* 27 (1990), and M.J. Roe, "A Political Theory of American Corporate Finance," 91 *Col. L. Rev.* 10 (1991).
 3. Most states limit total investments of insurance companies in common stocks to between 2 and 25 percent of assets, and investments in stock of individual companies are subject to even lower limits. W. McCown and S. Martinie, "State Regulation of Life Insurance Companies," *Association of Life Insurance Counsel Proceedings* 17, 1988.
 4. The Investment Company Act of 1940 and the Internal Revenue Code together provide "pass-through" tax treatment only to "diversified" mutual funds. At least half of the investments of a "diversified" fund must be in companies constituting at most 5 percent of the fund's portfolio and at most 10 percent of the company's outstanding stock. The other half can be in investments constituting no more than 25 percent of the fund's assets, but other restrictions apply if the fund owns 5 percent or more of a company's stock or has a representative on the company's board. In essence the 1940 Act almost insures that mutual funds will act only as passive investors but not as active corporate overseers. M.J. Roe, "Political and Legal Restraints on Ownership and Control of Public Companies," *J. Fin. Econ.* 27 (1990), p.13.

Table 1: OWNERSHIP OF COMMON STOCK--1970 AND 1988--as a Percentage of Total Outstanding Common Shares

	U.S. ^b	Japan	Germany ^d
1970			
Financial Institutions	15.8	34.9	12
Commercial Banks	0	11.6	8
Insurance Companies	2.9	15.4	} 4
Pension Funds	8.2	} 7.8	
Other Financial	4.7		0
Nonfinancial Business	9.1	21.8	39
Individuals	72.2	39.9	29
Foreigners	2.9	3.2	10
Other	0	0.2	10
1988			
Financial Institutions	30.4	51.2	22
Commercial Banks	0	18.9	10
Insurance Companies	4.6	19.6	} 12
Pension Funds	20.1	} 12.7	
Other Financial	5.7		0
Nonfinancial Business	14.1	24.9	42
Individuals	50.2	22.4	17
Foreigners	5.4	4.0	14
Other	0	0.7	5

Source: Prowse, S.D., "Comments on the Changing Role of Institutional Investors in the Financial and Governance Markets" in Sametz, A.W., ed. *Institutional Investing, The Challenges and Responsibilities of the 21st Century*, with later updates from the author.

^a Shares held in trusts are counted as individual holdings.

^b Intercorporate holdings estimated using methods employed in Tri (1971).

^c Holdings including preferred as well as common shares.

^d Most recent figures for Germany are for 1982.

a company must file with the SEC under the Securities Exchange Act⁵ and related rule, revealing ownership, plans, and sources of financing. Large holdings are also deterred by Section 16(b) of the Act, which disallows short-swing profits by shareholders owning more than 10 percent of a company's stock, regardless of whether inside information was involved.⁶ Finally, non-financial institutions are discouraged from owning shares of other companies by tax laws that subject dividends from intercorporate portfolio investments to multiple layers of taxation. As a result, it is not surprising that individuals own a major portion of shares in U.S. companies.

In contrast, institutions play a much larger role in Germany and Japan, where they have more latitude to own equity and exert active control over firms. In Germany, banks may own up to 100 percent of a company. Thus, banks and the investment companies they control have significant direct ownership interests in firms, and an even larger voice in monitoring due to their legal rights under existing proxy rules to vote the shares of clients for whom they act as custodian.⁷ In the typical large German firm, three banks control (through ownership or proxies) about 30 percent of the voting stock; in many of the largest companies, they have majority control. In comparison, the top five institutional shareholders in U.S. companies control on average about 5 percent of shares in large firms.⁸ Nonfinancial firms also have large equity holdings in Germany, as shown in Table 1.

Institutions play a large role in Japan as well. After World War II, the U.S. imposed on Japan a form of Glass-Steagall that disallowed bank ownership of more than 10 percent of a company's stock. This threshold was lowered to 5 percent in 1987. Despite this legal similarity with the U.S., Japanese banks are still influential in corporate governance because

5. Section 13 (d) of the Securities Exchange Act of 1934 requires any person who acquires more than 5 percent of any class of equity securities registered under the act to file a statement with the SEC within ten days after the purchase. It must describe the person's background, source of funds, the purpose of the acquisition, any plans for major changes in the target company, and any contracts or arrangements with any other person relating to the target company. Section 14(d) requires a person making a tender offer for more than 5 percent of any class of registered equity security to file a statement with the SEC describing the same information as above.

6. See Roe, supra note 4, p. 18.

7. Most shares in German companies are bearer shares, and shareholders often deposit the share certificates at their banks. Banks offer clients custodial services, including the handling of dividends and the voting of stock at the annual meetings. Before an annual meeting, the bank must recommend to its customers how to vote. Unless the customer gives the bank specific voting instructions (which is rare), the bank will vote the custodial shares on its own recommendation. In contrast, proxy rules in the U.S. cancel the voting rights of any shareholder that does not actively indicate a voting position or affirmatively delegate voting power to a proxy voter.

8. M.J. Roe, "Some Differences in Corporate Structure in Germany, Japan, and the United States," 102 Yale Law Journal 1, 1993.

of the "keiretsu" form of organization.⁹ Many other regulations that exist in the U.S. do not constrain Japanese banks, and the latter are much larger, more active, and more powerful in influencing the voting patterns of other keiretsu members than are banks in the U.S. Typically the "main" bank owns 5 percent of any industrial firm in the keiretsu¹⁰ and financial institutions in the keiretsu own some 20 percent more.¹¹ The role of these financial institutions is complemented by that of the other firms in the keiretsu who also own significant amounts of each other's stock. Financial institutions also own sizeable blocks of shares in firms that are not in keiretsu groupings, again due to less restrictive investment regulations. In total, banks, insurance companies, and pension funds together own about half of all outstanding shares of listed companies, and other nonfinancial firms own another quarter.

Corporate Governance and the Dispersion of Ownership

Theory and evidence in advanced market economies. The difficulty of shareholder monitoring in large corporations stems from the separation of ownership from management and the costs of collective action among disparate shareholders. Standard economic theory holds that wider ownership dispersion leads to greater shareholder passivity. This is because shareholders with small holdings will gain relatively little from improved company performance and thus will not have adequate incentive to invest the optimum amount of resources in monitoring. Rather, they have an incentive to "free ride" on others' efforts. However, if all shareholders take this apparently rational view, there will be no oversight at all, and managers will be free to misuse corporate resources and maximize their own personal gain rather than that of the company and its owners. Furthermore, with a large number of shareholders, the transaction costs of organizing shareholders to exert a unified voice are high, thus inhibiting collective action still further. In general, this theory suggests that shareholder monitoring is likely to be harder in larger firms--at least to the extent there are more owners, a greater separation of ownership and management, and higher information and transaction costs involved in collective action.¹² Owners of small companies are likely

9. "Keiretsu" are groups of firms and financial intermediaries that own large blocks of each other's stock and also deal with each other extensively on a commercial basis.

10. See Roe, *supra* note 8, pp. 22-26.

11. Roe, *id.*, p. 9.

12. The incentives are not always obvious even in this pure model, however. While small shareholder passivity is no doubt widespread, it should be noted that small holdings in a very large company may in fact translate into a significant individual gain from active involvement. Pound cites the case of Mobil, where a one percent share of total stock has a market value of some \$200 million. If faced with a corporate measure that could affect the stock price 20 percent (\$40 million) either way, the shareholder may prefer to spend the money to research and lobby on the issue (perhaps a few hundred thousand dollars) than to pay the commission (perhaps \$2 million) incurred upon sale of the stock. J. Pound, *supra* note 1, p. 83.

either to be managers themselves or to have the ability and the incentive to oversee management closely, but both the agency problems and the costs of monitoring rise as firms become larger and ownership more diffuse.

The availability of exit mechanisms will also affect an investor's incentive to participate in turning a company around. Thus, the presence of a highly liquid stock exchange (as in the U.S.), which provides a seller with ready buyer, may tempt shareholders to bail out of a troubled firm if the costs of that bailout are lower than the costs of reforming and monitoring management. A liquid market will also make it easier for outsiders to acquire troubled firms that they believe can be turned around with new management. Indeed, the lack of a more liquid stock market may be a partial explanation for the lack of takeover activity in both Germany and Japan.¹³

The results of research on the correlation between ownership concentration, managerial oversight, and company performance in advanced market economies is ambiguous.¹⁴ Some research does support the contention that more concentrated ownership leads to better corporate performance, particularly in low-tech, mature industries.¹⁵ Specific cases in which shareholder monitoring is known to have had a positive impact reinforce these statistical studies.¹⁶ Other research, however, fails to find a clear correlation between ownership dispersion and profitability in either the U.S.¹⁷ or Japan.¹⁸ Still other research questions the direction of causation implied by theory and hypothesizes that ownership structure may be a dependent rather than an independent variable. Demsetz and Lehn hypothesize that for some industries (for example, where firm-specific risk is high) concentrated ownership is advantageous while for others it may not be, and that market

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13. Although this relative illiquidity may be advantageous to the extent it heightens incentives for shareholder monitoring, there are offsetting disadvantages to the economy as a whole. One such disadvantage is the difficulty that small, somewhat risky new firms may have in obtaining financing. For example, some observers have questioned whether Apple Computer would have been able to grow and thrive in the German system.
 14. B. Black, "The Value of Institutional Investor Monitoring: The Empirical Evidence," 39 UCLA L. Rev. 895 (1992).
 15. Salancik & Pfeffer, "Effects of Ownership and Performance on Executive Tenure in U.S. Corporations," 23 Acad. Mgmt J. 653 (1980), and Zechhauser & Pound, "Are Large Shareholders Effective Monitors?: An Investigation of Share Ownership and Corporate Performance," in Asymmetric Information, Corporate Finance and Investment 149, 166-70 (R. Hubbard ed. 1990).
 16. See the examples of General Motors, Turner Broadcasting, and J.P. Morgan & Co. cited in Black, supra note 14.
 17. See, for example, Holderness & Sheehan, "The Role of Majority Shareholders in the Publicly Held Corporation," 20 J. Fin. Econ. 317 (1988).
 18. S. Prowse, "The Structure of Corporate Ownership in Japan," Journal of Finance 47:3, July 1992.

forces will push firms to the optimal result.¹⁹ This view meshes well with the characterization of shareholder monitoring as but one of many constraints facing managers: if other constraints (such as competition in product or capital markets) are tight, shareholder monitoring may be less important for efficiency.

Institutional ownership helps to address the "free rider" problems by combining widespread wealth distribution with concentrated shareholder voice.²⁰ As seen in Table 1, ownership by individuals fell significantly from 1970 to 1988 in all three countries, while institutional ownership rose. This evolution over the past few decades toward more institutional ownership in advanced market economies lends indirect support to the contention that more concentrated ownership--or at least more concentrated oversight (whether through exit or voice)--is likely to be associated with greater efficiency.

Implications for Central and Eastern Europe. In the CEE countries, the mode of privatization is likely to be the single most important factor determining the initial distribution of share ownership. Direct sales and management buyouts will produce concentrated direct ownership, employee buyouts will lead to a somewhat less concentrated form of direct ownership, and mass distribution programs (voucher schemes) will result in a widely dispersed shareholding body. If vouchers are used to buy shares in companies, this ownership will be direct; if they are used to buy shares in financial intermediaries, ownership of firms will be indirect (i.e. direct ownership will be by the intermediaries themselves). In all of these cases, patterns of ownership will change as stock markets develop and shares are traded, leading to greater or lesser dispersion. Given the relatively equal distribution of wealth and human capital in these countries, however, patterns of ownership may well continue to be quite widely dispersed, particularly in those countries that start out with mass privatization. *How to maintain efficient corporate governance while moving away from central administrative control toward widely dispersed ownership is a central issue throughout the region.*

If efficiency is the paramount concern, CEE countries would arguably be wise to push toward more concentrated ownership through direct sales of privatized firms to individual owners (in essence the Hungarian model). Problems associated with such sales, notably slowness and the scarcity of domestic capital, can be addressed without dispersing share ownership widely through voucher schemes. Foreigners with capital can be wooed as buyers, as has been done extensively in Hungary. Alternatively, implicit or explicit subsidies can lower the sale price so that domestic entrepreneurs can afford to purchase firms. If

19. Demsetz & Lehn, "The Structure of Corporate Ownership: Causes and Consequences," 93 J. Pol. Econ. 1155 (1985).

20. Some intermediaries, such as mutual funds, provide a concentrated voice but essentially leave shareholdings widely dispersed. Other institutions, such as insurance companies and pension funds, concentrate actual share ownership while distributing other wealth claims widely. Banks in Germany do both; they hold shares on their own account and vote the shares of entrusting private individuals.

efficiency is to be strictly pursued, these subsidies can be limited to insiders, who have privileged access to information and a direct influence in the company and are likely to act quickly with sufficient incentive. The spontaneous privatizations that have occurred (with or without official blessing) throughout Central and Eastern Europe are exactly this--cheap and quick sales to insiders. In Croatia, the privatization law provides for insider buyouts over several years at low cost.

A major constraint on direct sales to dominant owners--and also on corporate governance--in the CEE context is the sheer size of many firms. CEE firms are on average much larger than their counterparts in mature market economies, because concentrating production of a particular product in a single firm (the "one product-one firm" approach) minimized the transaction costs of central planning. Breaking up large firms prior to privatization may make sense not only from an antimonopoly perspective but also from a corporate governance one.

Furthermore, even if one accepts the view that concentrated ownership furthers corporate efficiency, there may be overriding reasons to favor more dispersed ownership patterns. In CEE, assets owned by the state during socialist times were in theory owned on behalf of "the people," and many now believe they should be returned to those same people. Socialist ideals of equality of wealth are still quite strong, and widespread distribution of share ownership, at least initially, fits those ideals. A further argument in favor of more dispersed share ownership is that wider ownership and increased trading of shares among the public facilitates the growth of a securities market. The mass privatization programs of CSFR, Poland, and Romania are in part rooted in such beliefs and on the desire to gain support for privatization among the population at large.

Widespread ownership and active shareholder monitoring are not necessarily incompatible and can best be achieved through the establishment of institutional intermediaries to hold and vote shares on behalf of individuals. Poland, Romania, and CSFR have recognized the value of institutional intermediaries by including them in the countries' mass privatization plans. The Polish and Romanian plans specifically set up investment funds to hold all shares of privatized firms on behalf of the public (which in turn owns shares in the intermediaries), while the CSFR plan allows the public to choose between direct shareholding in privatized entities or indirect shareholding through one of several competing investment funds. The free entry of intermediaries in the CSFR has a significant advantage over the "top-down" approach of Poland and Romania, in that it encourages both competition and specialization. Ultimate ownership patterns will be determined in large part by the extent to which individuals can and do invest their vouchers in the funds or in firms themselves. Experience in the "first wave" of CSFR privatization indicates that ownership of privatized firms may indeed be more concentrated than originally expected even in the case

of mass privatization, although the concentration will be more in the hands of institutional intermediaries than direct investors.²¹

Apart from investment funds, pension funds and insurance companies can also serve an analogous role of owning shares on behalf of individual investors. Although they have received less attention in the privatization debate, there has been some effort to encourage the growth of pension funds through privatization. Slovenia's recently-approved privatization law, for example, allocates 10 percent of the shares of privatized companies to government-established pension funds.²² Similarly, banks are entitled to own shares in companies in most CEE countries, and they may become substantial owners if debt is swapped for equity as proposed in some programs of joint bank/enterprise restructuring.

To encourage the growth of intermediaries, the CEE countries should avoid overregulating the involvement of intermediaries in companies. In the United States, the broad array of state and federal laws discussed earlier limits the ability of intermediaries to own large blocks of shares in individual firms. These various rules are intended to protect investors and workers by assuring diversification in the investment of their assets by intermediaries. While safety and soundness are certainly valid concerns, these rules seriously limit the ability of these institutional intermediaries to exert a voice in corporate governance.²³ In contrast, intermediaries in German and Japan are much less restricted, and as a result they exert a much larger voice in corporate governance. In the CEE environment, where the idea of corporate governance is so new and untested and where markets are not yet well-developed, encouraging active shareholder monitoring should be a high priority of policy makers. Intermediaries are likely to develop better access to information, closer ties to firm managers, greater experience and expertise in economic and financial matters, and deeper knowledge of the specific businesses in which they invest than individual investors

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21. J. Svejnar and M. Singer, "The Czechoslovak Voucher Privatization: An Assessment of Results," paper presented at the 1993 Meetings of the American Economic Association, January 1993.
 22. Another interesting example is Chile, where privatization efforts have been closely linked with the country's transition from a public pay-as-you-earn (PAYE) pension systems to a private fully-funded one.
 23. An alternative theory holds that institutional passivity has not resulted primarily from overregulation, but from the insufficiency of existing incentives to motivate institutional money managers to monitor. Where a fluid stock exchange is present, institutional investors would prefer to exit the corporation rather than reform it. Additionally, shareholders do not have the power to oust intermediaries' managers as they might in a corporation. For example, while corporate management is subject to the disciplinary threats of hostile takeovers, proxy fights, and other corporate control actions, managers of most institutional investors are not. Pension funds are immune from other capital market pressures in that they are creditors, not debtors (as corporations are). Even if an intermediary's substandard performance is detected, problems of collective action are potentially more severe at the institutional level than at the corporate level, mainly because among beneficiaries there is no analogue to the large shareholder who may be willing to become a monitor. See, J. Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor," 91 Col. L. Rev. 1277, 1283 (1991).

can develop.²⁴ For all of these reasons, their involvement in ownership and corporate governance in CEE is critical. The proper balance, when weighed against safety and soundness concerns, is likely to result in less stringent regulations on intermediary ownership than in the United States.

More concentrated and active participation of intermediaries in corporate governance will need to be accompanied, however, by regulation to encourage fiduciary responsibility and eliminate self-dealing by institutional shareholders. In other words, the intermediaries also need effective corporate governance, influenced both by their investor clients and by external government regulators. Protection of minority shareholders of the firms being governed is typically handled in company and securities laws, while both general and institution-specific laws on fiduciary responsibility protect shareholders in the intermediaries themselves. Such regulation will be difficult in the early years of reform due to the enormity of the challenge, the lack of strong market-oriented legal and regulatory institutions, and the general paucity of information and underdeveloped means for forcing its production (such as auditing and disclosure rules and "discovery" procedures).

Self-monitoring among intermediaries may also help to control self-dealing when other legal and/or cultural constraints are weak. In Japan, where external legal controls are particularly weak, observers stress the importance of the existence of several large shareholders in controlling self-dealing by any particular one.²⁵ To this end it might be useful to prevent outright majority ownership of large companies by one intermediary by imposing maximum limits (perhaps on the order of 25-35 percent) on their ownership of shares in any one firm.

In addition to encouraging the growth of responsible intermediaries, laws should minimize limits on the transferability of shares. To promote competition and the development of capital markets, shareholders should be encouraged to move their holdings among intermediaries and/or direct interests in companies. Furthermore, the evolution toward more concentrated ownership patterns should be allowed to proceed. A fair initial distribution of wealth may be desirable; restrictions that lock in that distribution are unlikely to be.

Corporate Governance and the Type of Owner

Theory and evidence in advanced market economies. The above discussion focused on the dispersion of ownership. Assuming a certain degree of ownership concentration, does it then matter to the effectiveness of shareholder monitoring *who* these owners are? Do different types of owners face different incentives that influence their goals in monitoring and

24. Because domestic expertise is likely to be scarce in the short-run, free entry of foreign expertise through management contracts or direct ownership should be encouraged.

25. See Roe, *supra* note 8.

their ability to monitor. Looking again at Table 1, one can see the variety of possible owners. Financial institutions can be shareholders on their own account (such as insurance companies, pension funds, and German or Japanese banks) or as intermediaries for others (such as mutual funds and bank trust departments or the equivalent). Nonfinancial businesses can own shares in each other merely as arms-length portfolio investors or as more interested parties linked together through regular commercial dealings (as in Japan). Individual shareholders can be merely external portfolio investors or can be insiders (whether managers, board members, or workers). Finally, the state can be a large shareholder, as it is likely to remain for some time in the CEE countries.

Different types of owners face different types of incentives to monitor corporate management. *The incentive to monitor can be enhanced by linking ownership ties with other economic relationships in an economy, i.e. by developing shareholders with a heightened interest in the ongoing performance of the firm ("linked" shareholders).* This is in essence the basis of the much-discussed models of corporate governance in Japan and Germany. Banks are significant owners of firms in both countries. These banks not only invest in these firms, but they lend to them on an ongoing basis.²⁶ Their simultaneous debt and equity interests appear to reduce the inherent conflicts between shareholders and debt holders, tempering both the incentive of shareholders to make suboptimal investments that compromise creditors' interests²⁷ and the incentive of creditors to recover debts at the expense of the firm's long-term interests. When a company encounters trouble, lenders who also hold equity interests are more likely to work with them on designing and financing restructuring and rehabilitation plans.²⁸ In contrast, if the only relationship was a creditor/debtor one, banks would have a stronger impetus to push an illiquid firm into bankruptcy before remaining assets are used or claimed by other creditors.

Banks are not the only shareholders that can have other, non-equity interests in firms. Companies that deal with each other commercially also have extensive cross-holdings of equity, which increases their incentive to monitor the health of these commercial partners, rather than simply exit in times of trouble. In Japan, for example, Mitsubishi Heavy

26. In one study of 85 keiretsu, the largest shareholder is also the largest creditor in 55 cases. In most keiretsu firms, the majority of its debt is held by other keiretsu members, whether financial institutions or nonfinancial firms that extend trade credit. S. Prowse, *supra* note 18. It should be noted, however, that the past decade has seen a significant switch in Japanese enterprise finance away from "main bank" financing toward more arms-length financing through the corporate bond market. This shift followed Japanese legislation that make it easier for Japanese firms to issue bonds, which were themselves more marketable due to the growth in profitability and reputation of Japanese industry. D. Scharfstein, *supra* note 1.

27. M.C. Jensen and W. Meckling, "The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *J. Fin. Econ.* 3, 305-360, and S. Prowse, *supra* note 2.

28. T. Hoshi, A. Kashyap, and D. Scharfstein, "The Role of Banks in Reducing the Costs of Financial Distress in Japan," *J. Fin. Econ.* 27, 1990.

Industries is the largest shareholder in Mitsubishi Steel and also an important supplier of its equipment and large purchaser of its output.²⁹ Again, the two economic relationships can work to reinforce one another.³⁰ In addition to assisting a troubled company, a firm is more likely to fulfill its commercial obligations to another firm that is also an owner; if a dispute arises, the cross-holdings between the parties give them a greater incentive to find a negotiated solution that preserves the longer-term commercial relationship. In this way corporate cross-holdings can serve as an informal mechanism of contract enforcement, to a large extent substituting for more formal legal procedures. Extensive corporate cross-holdings may well help to account, for example, for the relatively small number of commercial law cases in Japan, when compared with the U.S..

The above two examples show how overlapping debt/equity or sales/equity contracts can reinforce shareholder monitoring and effective corporate governance. A third possible overlap is between labor and equity contracts. Ownership of stock by "insiders" enhances shareholder monitoring, because employees have both more information about company performance and more to lose if such performance is poor. Insiders can be either company managers and directors, or employees at all levels. The former is common in the United States, where manager or director compensation is often tied to company performance through stock options and other performance-based compensation schemes.³¹ This is less common in Japan, where managers own little stock in their own companies than in the U.S.³² Although empirical evidence on the impact of insider ownership by officers and directors in the U.S. is mixed, it seems to give modest support to the view that some inside ownership is likely to improve performance.³³

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29. C. Kester, Japanese Takeovers: The Global Contest for Corporate Control, Cambridge: Harvard Business School Press, 1990.
 30. R.J. Gilson and M.J. Roe, "Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization," Columbia Law School, Center for Law & Economic Studies Working Paper, August 1992.
 31. One study found that the average combined ownership of all board members in a sample of Fortune 500 firms was 10.6 percent. R. Morch, A. Schleifer, and R. Vishny, "Management Ownership and Market Valuation: An Empirical Analysis," J. Fin. Econ. 20, 1988.
 32. For example, a recent study of a sample of large Japanese and U.S. firms found that only 12.2 percent of the Japanese presidents held more than 0.5% percent of their company's stock in 1981, compared to 22.6 percent of the U.S. CEOs. S. Kaplan, "Internal Corporate Governance in Japan and the U.S.: Differences in Activity and Horizons," unpublished manuscript, U. Chicago. Another set of studies found that the average U.S. CEO owns about 1.8 percent of his company's stock, compared to about .25 percent for the average Japanese company president. S. Kaplan, "Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S.," draft paper, University of Chicago Graduate School of Business, July 1992. Explicit profit sharing contracts are also rare with Japanese management circles. C. Kester, "Capital and Ownership Structure: A Comparison of United States and Japanese Manufacturing Corporations," Financial Management, Spring 1986.
 33. This evidence is reviewed in Black, supra note 14, pp. 23-27.

Stock ownership by non-managerial employees is being pushed in the U.S. through Employee Stock Ownership Plans ("ESOPs") and is a common theme in several privatization proposals in CEE countries.³⁴ There is an unresolved debate concerning the effect of ESOP-type programs on company performance.³⁵ On the one hand, employee ownership can in theory enhance the productivity of employees and managers by increasing both the return worker-shareholders receives from increased work effort and the information available to those worker-shareholders in monitoring managers. Like the two earlier examples of interrelated contractual arrangements, the employee-employer relationship and the shareholder-firm relationship reinforce one another to strengthen each. On the other hand, some fear that employee ownership retards labor mobility and impedes managerial freedom. The weight of empirical evidence seems to suggest that employee ownership does not reduce productivity and may enhance it, especially if it combined with direct employee participation in firm decision making.³⁶

In the three examples of "linked shareholders" discussed above--i.e. with banks, suppliers/purchasers, and employees--the importance of the linkage depends in part of the role and viability of the formal legal system in enforcing contracts. This was noted earlier with regard to commercial contracts in Japan; the same holds in theory for the other types of contracts. The equity link becomes more important if debt collection is difficult (in the case of banks) or if labor contracts are unreliable (in the case of employees). The additional commitment, power, information, and "voice" gained by shareholders through equity ownership gives both parties greater incentive to resolve differences regarding debt or labor contracts and thus preserve their long-term relationships.

In addition to the question of incentive is that of *ability* to monitor. The ability to monitor is first and foremost tied to access to information. Often, access to company information depends upon the nature of one's relationship with the company. For example, lenders that require certain information for loan assessment automatically have information equally relevant to investment planning. They are also able to maintain a close relationship with management during the term of a loan. Given this natural insider's position, in addition to their accumulated experience in making many loans, banks are likely to be well-positioned to take a lead in corporate governance. The same may be true for institutional investors that have the power to demand information and the resources and expertise to interpret it adequately. Commercial partners, e.g. in Japan, can gain extensive information on the

34. For example, the Polish privatization law calls for the distribution of up to 10 percent of the shares of privatized companies to employees, and the Slovene law calls for the sale of 20 percent of such shares to employees at reduced price. More generally, the latter law is designed to promote insider ownership and control of privatized firms by giving insiders the right to purchase the bulk of company shares over time at "book" value.

35. For a summary of the arguments, see Barbara Lee, "Should Employee Participation Be Part of Privatization?", World Bank Working Paper 664, May 1991.

36. Lee, *id.* p. 10.

health of each others' firms by observing directly their behavior in commercial dealings. In all of these cases contractual linkages lead to greater information and thus enhance the ability of shareholders to monitor management.

Implications for Central and Eastern Europe. On the one hand, certain characteristics of the CEE environment reinforce this argument in favor of contractual linkages. First, the relative weakness of other market constraints on managers (such as competition in product or capital markets) makes shareholder monitoring--and any links that enhance it--particularly critical. Second, the weakness of accounting and other information systems and resulting lack of information available to "outsiders" strengthens the need to involve those with direct information (including contracting partners) in the oversight process. Furthermore, a U.S.-type system requires not only extensive access to information, but also a large network of people (stockbrokers, credit rating agencies, regulators, venture capitalists, etc.) able to evaluate such information. Such expertise is likely to be scarce in Central and Eastern Europe for some time to come. Finally, the lack of experience and relative incapacity of the formal legal system in enforcing contracts heightens the need for other, less formal incentives for parties to abide by contracts. Indeed, in this environment the pattern of equity ownership may be the key not only to corporate governance but also to smooth contractual relationships in many areas of the economy.

On the other hand, contractual interlinkages such as those suggested above can be dangerous if the entire system lacks discipline and accountability, as is true in much of the CEE region. For example, if banks lack adequate prudential supervision, they may make both bad investment decisions and bad loans and thus become integrally intertwined in a downward-spiraling economic relationship with weak firms. Similarly, strong equity and supply interlinkages among firms may lead to a "domino" affect whereby each firm's health depends so heavily on the health of the others that they continually bail each other out rather than risking the collapse of the entire system. A key to avoiding this downward spiral in the case of banks is strong prudential supervision by an independent body, generally the central bank, combined with market competition. Other intermediaries, such as mutual funds or pension funds, will also be effective corporate owners and overseers only if they themselves are well-governed, adequately regulated, and subject to market discipline. External discipline is also important in the case of interfirm ownership, but here the bulk of the discipline must come from market forces, supplemented in special cases by the limits imposed by antimonopoly legislation. *In sum, strengthening the role of "linked" owners is likely to improve corporate governance, provided prudential regulation and market forces (including competition from international trade) are strong enough to provide some external discipline and accountability to the system as a whole.*

The role of existing banks in corporate ownership and governance in CEE is currently the subject of intense debate. As noted above, banks potentially possess both the incentives and the information needed to exert a very positive influence as shareholders. However, existing banks are heavily laden with bad debts, weak incentives, poorly trained staff, and inefficient procedures, all carried over from socialism. In the CEE context it is important to

distinguish between different types of actual or potential lenders: (1) old banks, which have a legacy of problems and ingrained habits carried over from socialism and are themselves usually in need of restructuring; (2) new banks, which may or may not be viable entities but in any case face a different set of problems and incentives; and (3) privatization intermediaries, which could potentially take on an expanded lending role in the future but face yet another set of potential problems. Some observers believe that the current banking systems are not worth salvaging, and that they should be phased out and gradually replaced by new banking institutions. Others believe that existing banks can be salvaged to play a useful corporate governance role if their existing stock of bad debts is lifted (replaced at least in part with equity through debt-equity swaps) and if they are privatized to create profit-maximizing incentives. More in-depth research is needed to throw light on this debate. Ultimately the answer is more likely to be case-by-case than across the board, because both the capabilities of existing banks and the ease of building new institutions is likely to vary by country.

Translating Ownership into Control: The Corporate Legal Framework

In addition to laws regulating ownership, the second major variable that influences the effectiveness of shareholder monitoring is the legal framework in which such monitoring takes place. This legal framework--contained primarily in company laws, securities laws, rules of the stock exchange, competition laws, and laws on fiduciary responsibility--defines the power of shareholders, oversight boards, and outsiders to observe and influence managerial behavior.

Shareholder Rights and Powers

Numerous legal rules, contained primarily in company laws, affect the way a firm's ownership structure is translated into shareholder influence through voting. The company laws of CEE countries provide extensive flexibility for each company to adjust voting rights to suit its own needs (Table 2). This flexibility is generally desirable because it allows control to be distributed differently from ownership. It is particularly appropriate for CEE in the short-run, in that it allows focused control (crucial for quick, effective restructuring) in the absence of concentrated ownership or custodial voting power.

First, shares can be assigned different voting rights. In the U.S., companies may issue stock carrying more than one vote; however, firms listed on the New York Stock Exchange must comply with the one share-one vote rule. Under Japan's company law, all common stock is subject to the one-vote rule.³⁷ Germany's company law has a similar one-share one-vote rule, although companies may issue multiple-vote shares in exceptional

37. Article 241.

Table 2: PROVISIONS OF CEE COMPANY LAWS¹

	Poland	CSFR	Hungary	Romania	Bulgaria
Voting Rules					
Votes per share	1 to 5	1	Apparently unlimited	1	1
Votes per shareholder	May be limited	May be limited	May be limited	May be limited	Statute appears silent
Minimum Quorum Requirements	Statute appears silent	30 %	> 50 %	50 %	Determined in Articles of Association
Minimum Majority Requirements					
--resolutions	> 50 % unless Articles state otherwise	> 50 %	> 50 %	> 50 %	> 50 % unless Articles state otherwise
--fundamental changes	75 %	66 %	75 %	50 % (2/3 of a 75 % quorum)	> 50 % unless decided by management
--electing management	Statute appears silent	> 50 % unless task of Sup. Board	> 50 %	Task of Board	> 50 % unless task of Sup. Board
--removing directors, supervisors	> 50 %	> 50 % unless task of Sup. Board	> 50 %	> 50 %	> 50 %
Board Structure					
Two Tiers Required	When stock exceeds Zl 5 bill.	Always	Always	Not required	Optional
Employee Representation on Supervisory Board	No special provisions	May elect 1/3-1/2 if over 50 employees	May elect 1/3 if employees average 200	No special provisions	No special provisions

¹ Source: CEE company legislation. This information is tentative because the laws are often unclear. Furthermore, actual practice may vary considerably from these legal guidelines.

circumstances (if the public interest will be furthered).³⁸ In all cases, preferred shares--i.e. non-voting shares with a dividend preference--are allowed. While the one share-one vote rule accords with intrinsic notions of fairness, it does not enhance the effectiveness of shareholder monitoring under conditions of widely disbursed ownership.

In the CEE countries, many company laws allow different shares to be assigned different voting rights. In Poland, for example, one share can have up to 5 votes.³⁹ In CSFR,⁴⁰ Hungary,⁴¹ and Romania,⁴² the total votes of certain shareholders can be limited in the company statute. In this way ownership can be widely disbursed yet more active and/or experienced shareholders can have greater weight in corporate decisionmaking.

Second, quorum and/or majority voting rules can be adjusted to shift the powers of corporate voting blocks. Company laws generally set minimum requirements for both quorums and voting majorities, although companies are free to set their own rules above these minimum levels. Low quorum figures (say 30 percent) or majority vote requirements give minority blockholders more power to push through their own initiatives if other shareholders are passive; high requirements (say 70 percent) give minority blockholders more power to veto the majority simply by not "showing up" or by voting against a proposal. The former is likely to be desirable if strong action is needed in the face of many dispersed and passive shareholders, as may be the case in countries pursuing voucher schemes of privatization. The latter may be desirable in certain cases of less dispersed ownership where a minority shareholder wants firm control over the actions of the majority shareholder, as may be the case in joint ventures.

In the U.S. the lowest possible quorum figure is 33 percent, whereas in Japan it is 50 percent. Germany has no minimum quorum rule. The U.S., Japan, and Germany all require at least a simple majority (50 percent) to pass general resolutions, but minimum required majorities for fundamental changes (including amending the articles of association, mergers, or dissolution) range from a simple majority (in the U.S.)⁴³ to 66 percent (in Japan) to 75 percent (in Germany).

38. Aktiengesellschaftensrecht (Law on Stock Corporations), Section 12(2). But see Section 134, which implies that "the articles of association may limit the right to vote through establishment of a higher amount or of graduated scales."

39. Article 358.

40. Para. 180.

41. Article 269.

42. Article 67.

43. In practice over the past few years, company statutes have increased this percentage as an anti-takeover measure.

The company laws of CEE vary to about the same extent and provide highly desirable flexibility for companies to set rules that best suit their individual needs. The CSFR company law provides a minimum quorum of 30 percent and requires a simple majority for most decisions, although either requirement can be increased by company statute. The company laws of other CEE countries generally have quorum and majority voting rules of 50 percent unless the company's articles provide otherwise. Most of the CEE laws require supramajority (two-thirds or three-quarters) votes at the general meeting for some important decisions, such as changes in the company's articles, changes in the rights of certain classes of shareholders, or sale, merger, or dissolution of the company.

Third, the voting power of certain shareholders on issues that most concern them (such as choice of directors) can be enhanced through "cumulative voting" rules. Cumulative voting was developed primarily to give minority shareholders a greater chance of representation on the board of directors. The system entitles each shareholder a number of votes equal to the number of directors being elected and allows the shareholder to distribute those votes among candidates as he or she chooses. Thus, all votes can be cast for one candidate, unlike traditional voting systems in which a shareholder is entitled to cast only one vote per seat. Minority shareholders can thus elect some directors to the board, even if majority shareholders oppose such election, and thereby get a "foot in the door" and increase both pressure on managers and the chances for a change in control. Although cumulative voting has been adopted in certain U.S. states (most notably California, where it is mandatory) and as an option (albeit rarely-used) for companies in Japan, it seems as yet unknown in CEE countries.

Fourth, proxy rules can mobilize the votes of otherwise passive shareholders. Proxy rules are intended as a device to inform voters about issues and candidates and let them exercise their "ownership voice" through designated agents rather than attend shareholder meetings in person. The impact of the proxy process on corporate governance depends heavily on the specific rules regarding access to information, expense allocation, custodial powers, and control over the process itself. In the U.S. and Japan, incumbent managers prepare ballots and make formal recommendations on the items submitted for shareholder vote. The shareholder then has the opportunity to vote in person or through a proxy (to which the shareholder may give specific voting instructions or may delegate the voting decision). If the shareholder does nothing, that vote is never counted. Access to shareholder lists in the U.S. tends to be controlled by incumbent managers and directors (who are required to disclose them only to shareholders with a "legitimate business purpose"), making it hard for dissident shareholders to lobby others to vote against incumbent's recommendations. In addition, dissident candidates and proposers of resolutions must pay for the reproduction and mailings of their proxy ballots, whereas management's are paid for by the corporation.

In contrast, German rules on both proxies and custodial rights give banks, in their status as custodians to shareholders, great power to recommend positions independent from that of management. Banks submit their own recommendations to the shareholders for whom

they serve as custodians. Unless those shareholders specify voting instructions, the banks are entitled to vote those shares according to their recommendations. Thus, in Germany the vote of a passive shareholder is voted by an active shareholder, where as in the U.S. case the passive shareholder's vote is lost. Not only are more votes cast, but the votes of passive shareholders are arguably more likely to be cast in their best interests. Most passive shareholders who vote in the U.S. vote along with management, even though management's proposal may not be compatible with the shareholder's interest. In the German model, passive shareholders' votes will support the custodial bank's recommendation, which may sometimes differ from that of management.

The oversight role of intermediaries in the CEE countries will be strengthened if their proxy-voting powers are enhanced, as in the German model. Most CEE company laws provide for proxy voting if a shareholder cannot attend a general meeting. It is unclear, however, whether or not a custodial system as in Germany exists or will develop and, if so, whether custodians (or other intermediaries) can vote proxies for affiliated shareholders. It is also unclear how easy it will be for shareholders to obtain access to shareholder lists to try to influence proxy voting, and, if so, who will bear the costs of mailings to shareholders.

The Role of Oversight Bodies

The advanced market economies. Because few shareholders can actively monitor the day-to-day activities of management, they elect representatives to do the job for them. Corporations in the U.S. and Japan have boards of directors. U.S. boards are typically composed of both inside officers and outsiders, while Japanese boards are composed entirely of insiders. The board appoints the chief executive officer of the company, who in turn appoints other officers. In addition to selecting (and dismissing) management, the board approves major decisions, such as declarations of dividends, corporate borrowing, and other business strategies. It also approves proposals for mergers, sales of substantial corporate assets, and dissolution, which are then subject to shareholder vote.

Although members of the board are elected by the shareholders, boards of U.S. companies have often been seen as partners of incumbent management rather than protectors of shareholders' rights. For example, management maintains significant power over the board through its ability to recommend board candidates during elections (as most proxy voters follow management's recommendations). In recent years there has been a stronger push, particularly from larger institutional shareholders, to appoint more independent members to corporate boards, and much of the literature on U.S. corporate governance emphasizes this as a primary direction of reform in the future.⁴⁴

44. For example, Pound identifies numerous means by which investors are attempting to exert more independent voice, including not only slates of independent directors but also shareholder-sponsored "shadow" management committees and outside experts to critique specific operating policies. See Pound, *supra* note 1.

In contrast, oversight bodies have always been significantly more independent in Germany. Each German corporation has a management board and a supervisory board. The former is responsible for running the company on a day-to-day basis, while the latter is composed exclusively of outsiders. Unlike in the U.S. case, members of the management board may not sit on the supervisory board, and vice versa. The supervisory board has two main responsibilities--to supervise the management board and to appoint all of its members (not just the chief officer) for five-year terms. The members of the management board may be fired only for cause and thus maintain a fair amount of independence in their day-to-day decisionmaking.

Much of the independence of German supervisory boards arises from the more concentrated patterns of ownership in German firms. Because supervisors are elected by shareholders, and banks control many votes, banks typically have one or more appointees (often including the chairperson), who are viewed as direct representatives of those banks. Similarly, under the policy of "codetermination," employees are entitled to elect one-half of the supervisory board. These appointees are neither beholden to management nor loyal to a diffuse, abstract shareholder body. As a result, their loyalties are concentrated and concrete, which insures greater independence from management. In most cases no one shareholder has absolute control, but a coalition of independent shareholders does.

Although the formal Japanese oversight structure resembles that of the U.S., the balance of power between managers and shareholders in Japan appears in reality to be closer to that of Germany. The more concentrated institutional ownership of individual firms and the interlocking business relationships within the keiretsu both strengthen the voice of shareholder representatives, functioning in Japan not so much through formal board meetings as through less formal monthly meetings of the Presidents' Council. Again, shareholders are not mere abstractions but are clearly represented in their various representatives, who are not as psychologically, socially, or financially dependent on the CEO as in the U.S.⁴⁵

Governance power in all three countries is also related to the power to set compensation levels for overseers and managers. The compensation of outside board members is not usually controversial. Because a certain prestige is associated with board membership, compensation is rarely the prime motivating factor for such individuals. Thus, compensation is typically modest and must be approved by shareholders. In contrast, management compensation is much higher, particularly in the U.S.,⁴⁶ making it a source of increasing controversy. Shareholders vote on managerial compensation in the U.S. and Japan, but the proposed packages on which they are voting are often so complex that

45. Roe, supra note 8, p. 26.

46. Managerial compensation is typically much smaller in Japan than in the U.S.. Takao Kato and Mark Rockel, "Experiences, credentials and compensation in the Japanese and U.S. managerial labor markets: Evidence from new micro data," Journal of the Japanese and International Economies 6, 1992, pp. 30-51.

assessment of their value is difficult.⁴⁷ Supervisory boards determine the salaries of German managers. Recent research appears to indicate that management turnover, and to some extent managerial compensation, does bear some (albeit limited) relation in all three countries to firm performance (particularly if such performance, whether measured through stock price or through earnings, is negative).⁴⁸

Central and Eastern Europe. The CEE countries have generally followed the German model of oversight for joint stock companies,⁴⁹ providing for hands-on management by an administrative board (sometimes called a board of directors or management board) and oversight functions by an independent supervisory board. Independent auditors may also be required for larger countries. In both law and practice, the division of responsibility among these various bodies can vary greatly by company (within general guidelines set out in the laws). Bulgaria has a hybrid system, in that a joint stock company can have either a "two-tier" system (management and supervisory boards) or a more simple "one-tier" system (a board of directors only). Romania differs from the others in that its company law does not provide for a supervisory board, although its "Board of Administration" may delegate some of its powers to a managing committee,⁵⁰ thus in effect creating a system somewhat like the others.

Control over the selection of board members greatly affects their independence. The company laws of CSFR,⁵¹ Hungary,⁵² and Poland⁵³ allow both the board of directors and the supervisory board to be elected directly by shareholders, arguably making the board of directors less directly accountable to the supervisory board. In the CSFR⁵⁴ and Polish⁵⁵

47. Recent SEC regulations have required U.S. companies to report executive compensation in a more transparent manner, making it easier for shareholders to evaluate the total package.

48. S. Kaplan, *supra* note 32; S. Kaplan, "Top Executives, Turnover and Firm Performance in Germany," draft paper, University of Chicago Graduate School of Business, February 1993; M. Jensen and K. Murphy, "Performance Pay and Top Management Incentives," *J. Pol. Econ.* 98, 1990, pp. 225-264.

49. Management and oversight structures are generally simpler for limited liability companies than for joint stock companies, reflecting their smaller number of owners and the underlying assumption that the owners know each other and have regular contacts.

50. Article 98.

51. Para. 194.

52. Article 285 (3).

53. Articles 366 (3), 379 (1).

54. Para. 194 (1).

55. Article 366 (3).

cases, the company statutes may change this by providing (as in Germany) that the supervisory board elects and dismisses the members of the board of directors, and in Poland the supervisory board may suspend "for serious reasons" members of the board of directors elected by the general meeting.⁵⁶ Bulgaria follows the German model in its two-tier system, providing that members of the management board are elected and recalled by the supervisory board.⁵⁷ In all of the two-tier systems, persons cannot serve on both boards simultaneously. In Romania, in contrast, the head of the managing committee must also be a member of the administrative board--and arrangement similar to the U.S. (with the attendant lack of independence).

An additional issue is the role of workers in the selection of overseers. CSFR and Hungary follow the German model of codetermination in large companies (defined as those with over 50 and 200 employees, respectively) by giving employees the right to elect one-third of the supervisory board. The wisdom of this policy is widely debated. On the one hand, employee representation may help to improve worker-manager relations, thereby decreasing strikes and other worker disruptions and increasing worker productivity. On the other hand, some believe that it skews company policy in favor of workers as opposed to shareholders and lowers company efficiency and growth.

These governance systems are largely untested in the CEE context because of the small size of the private sector in general and the particular shortage of widely held medium- and large-sized private companies. On the positive side, the countries' company laws try to establish checks and balances by requiring independent oversight bodies, whether supervisory boards or auditors or both. They draw a clear line between management and oversight by eliminating overlapping membership in the two bodies. Some try to accommodate the interests of workers through allowing them representation on supervisory boards. Yet it is unclear whether these provisions alone will lead to independent corporate governance. A major lesson of the U.S., German, and Japanese experiences is that the efficacy of oversight bodies, which depends in large part on their degree of independence from management, is correlated with the degree of concentration of share ownership. If shareholding or share voting rights (via proxies) are relatively concentrated, then members of oversight bodies are likely to be more independent from management in practice than if shareholding and voting rights are diffuse.

Oversight bodies, no matter how well-designed, will not function adequately if the members lack competence and are not held to high standards of fiduciary responsibility. Relative to the sharply rising demand resulting both from privatization and from "corporatization" of the state sector, there is a severe shortage of persons in CEE countries who have the requisite knowledge to be effective board members. Although time, experience, and training will help ameliorate this problem in the medium-term, it will

56. Article 383.

57. Article 241 (2).

seriously affect prospects for effective corporate governance in the short run. Limiting the number of members of boards to the minimum allowable by law and including some foreigners as members can help. Allowing people to serve as directors on several boards may also help, but this advantage must be weighed against two potential disadvantages: (1) conflicts of interest that could arise if one person were serving on the boards of competing companies, and (2) the collective disincentives for strong and honest oversight that could arise in an entrenched body of interlocking directorates.

With regard to standards of conduct, the powers of managers and members of oversight boards need to be moderated to prevent self-dealing and protect the rights of minority shareholders and the general public. In most market economies, managers and directors are held to a general standard of reasonable care, but the extent to which this standard is enforced depends on a variety of factors, including culture and access to information on managerial or supervisory behavior. Among the advanced market economies, law suits alleging fiduciary irresponsibility have been most common in the U.S., and many have been related to takeover battles in which shareholders believed their interests were being sacrificed to those of incumbent managers and directors. In both Germany and Japan, shareholder suits are much rarer. In Germany there are no legal restrictions on such suits, but the awareness of shareholder rights has developed more slowly than in the U.S., due to the large role of the banks. Furthermore, in their capacity as liaison between shareholding clients and companies, banks control the flow of information between the two, thereby checking shareholder litigation. Under Japanese law shareholders may sue their managers and directors, but cultural preference for private negotiation over public litigation reduces the number of shareholder suits. Of course, this private negotiation is available primarily to more influential shareholders or coalitions of smaller shareholders.

Most of the company laws and civil codes of CEE countries establish a general standard of due care for directors and officers. Their legal institutions, however, are not well-developed and may have difficulty playing a major role in enforcing this standard in the near-term.

Disclosure Rules

The competence both of shareholders in their voting decisions and of supervisors in their governance is fundamentally affected by the availability of information. An effective legal infrastructure is needed to specify and enforce disclosure standards for all companies, especially those issuing securities to the public. Stringent disclosure rules are appropriate in the CEE context. These rules need not impose detailed SEC-type reporting requirements but rather can require widespread disclosure of routine accounting information prepared according to standard international accounting principles. Financial reporting lies at the core of business accountability. Such reporting provides investors with the most basic information required to assess the risk and value of an investment, and thus helps share prices fully reflect share values. Financial disclosure rules should be uniform across industries to avoid information and price asymmetries--i.e. under- or overpriced securities--that skew investment

decisions. Stringent disclosure rules should also apply to other items, such as business plans and projections, events that may affect stock prices, managerial compensation,⁵⁸ and shareholder lists.

Differences in accounting standards can have major implications. For example, whereas U.S. companies must disclose figures on their reserve accounts, German companies are not required to reveal these figures. Thus, German profit statements may not be entirely accurate if, for example, the company borrows from the reserve account to enhance profits. Due to this disclosure policy, German stocks are prohibited from being listed on SEC-regulated exchanges in the U.S., although the increasing need for foreign capital may result in reconsideration of this policy in the U.S.⁵⁹ Indeed, numerous national exchanges are moving to relax reporting requirements for foreign firms.⁶⁰

The frequency of reporting may also affect corporate activity. For example, the U.S. Securities and Exchange Commission (SEC) requires that publicly held companies prepare financial reports on a quarterly basis. This has been criticized for fostering short-term pressures on management, which often result in moves designed to enhance quarterly reports (e.g. selling off assets, cutting research, or laying off employees) at the expense of long-term investments. In contrast, German and Japanese companies produce profit/loss statements either annually or semi-annually,⁶¹ a frequency that is probably appropriate for CEE countries as well.

Of course, any legal rules must be enforceable to be effective, and the weakness of enforcement capacity in the public sector may constrain governance capacity in the private sector. Furthermore, disclosure rules may not by themselves be sufficient if shareholding is

58. It is interesting to note that the U.S. SEC has just tightened its disclosure standards on managerial compensation, in response to the loud and growing dissatisfaction among shareholders with the high levels of executive salaries and their seeming scant relation to performance. D. S. Hilzenrath, "Shareholder Rights Expand", Washington Post, October 16, 1992, p. 1.

59. The European banking industry has recently faced a similar disclosure issue. The International Accounting Standards Committee (IASC) has recently issued Standard 30, which prohibits hidden reserves for loan losses and other banking risks. Despite the lack of enforceability of IASC standards, the European Community and its banks are increasingly recognizing the advantages of full disclosure (greater access to international financial markets, improved shareholder relations) over the advantages of hidden reserves. Financial World, vol. 160, No. 5, Mar. 5, 1991, p. 34-35. For example, in response to demands from international investors and competition from non-German depository banks, Deutsche Bank became the first German bank to publish its full operating profits. Economist, June 22, 1991, p. 79.

60. Accounting Horizons, vol. 5, no. 3, Sept. 1991, p. 69-80.

61. The US also requires disclosure of a 5-10 year historical development of sales, net income, and other important data, in order to give investors a longer-term view of the company. Japan has no such requirement.

widely dispersed and shareholders lack the means or incentive to verify the information disclosed. Thus, these rules should be accompanied by external auditing requirements. The audit of the annual financial statements by independent and qualified auditors underpins disclosure rules and is a key element of corporate governance.

Outsiders and the Market for Corporate Control

Corporate and securities laws not only determine the competence of shareholders and their inside representatives in overseeing management, but they also determine the ease with which outsiders can affect management through the market for corporate control--i.e. through takeover. The typical targets for takeovers are firms whose share prices are perceived by outsiders to be lower than the company's true worth. If such undervaluation is seen to result from inefficient management, a successful acquirer will replace incumbent managers. In this way, the securities market imposes a discipline on managers by exposing their companies to possible takeovers and themselves to likely replacement. That very discipline creates complex conflicts of interest, however, between managers, directors, and shareholders. Managers are typically against involuntary takeovers, because they are likely to lose their jobs. Shareholders can benefit from such takeovers, however, if the new managers are more efficient; empirical studies of mergers and other acquisitions show that most takeovers result in rising share prices.⁶² Directors are caught in the middle; they also risk losing their positions on the Board if the takeover succeeds, but their fiduciary duties and often their day-to-day interests are clearly tied to those of the shareholders they represent.

One crucial legal issue is thus the distribution of decision making authority among management, the board, and shareholders. Because the decision to entertain a takeover bid usually begins (and often ends) with the board, the crux of the controversy is the extent of shareholder, particularly minority shareholder, participation in takeover decisions. Some argue that, as residual claimants who stand the most to gain or lose in such a move, shareholders should be entitled to vote on takeover decisions. This extra monitoring device supplements their most basic power, the ability to oust directors. The counterargument is that shareholders are passive investors who delegate business decisions to directors, and since mergers are one kind of business decision, power to approve or reject them should remain with those most qualified to make them.

Other aspects of corporate and securities laws also help determine the power of the incumbent management and board, and thus the ease with which outsiders can affect management through the takeover market. Liquid stock markets and tough disclosure rules (including disclosure of shareholder lists) make takeovers easier, while anti-takeover

62. Easterbrook and Fischel, "Voting in Corporate Law," 26 *J. Law & Econ.* 395, 416 (1983). On the other hand, highly leveraged takeovers can be destructive, as is evidenced in the U.S. by the bankruptcies following the mergers and acquisitions of the 1980s. "LBOs of the '80s Become Prepackaged Bankruptcies of the '90s," *Business Credit*, October 1991, p. 15.

legislation,⁶³ "poison pills,"⁶⁴ and restrictive voting rules all make takeovers more difficult.

The market for corporate control has been very active in the U.S., particularly in the 1980s. In contrast, hostile takeovers have been rare in Japan.⁶⁵ The reason is partially legal in nature. Although Japanese takeover rules are modelled on those of the U.S., certain legal provisions inhibited hostile takeover activity throughout the 1980s. For example, Japanese boards of directors were entitled to defend against takeover attempts by issuing low-priced shares to friendly companies ("white knights") in order to dilute the percentage of the hostile buyer⁶⁶ without sacrificing practical control of the company. No shareholder vote was required for such move. Although such defensive moves are no longer possible, takeovers will probably continue to be rare for structural and cultural reasons. On the structural side, the large percentage of shares owned by long-term shareholders with close business ties to the company makes many buyouts prohibitively costly. On the cultural side, it is thought that a hostile takeover would destroy the target company's sense of "wa," or internal harmony, making it difficult to integrate the target into the acquiring "keiretsu".⁶⁷

Similarly, hostile takeovers have been less common in Germany than in the U.S.. The reliance of German firms on debt rather than equity financing has had two major implications: first, companies have tended not to look to equity markets for capital, which

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63. This legislation, appearing recently in the U.S. and the U.K., makes takeovers more time consuming and expensive. For example, it may require that a bidder who acquires 30% of a company bid for the entire company. In addition, bidders must also disclose significant stakes early on and stick to a measured timetable in building up these stakes, which permits share prices to increase (as opposed to sudden buyouts, which tend to drive prices down due to the "prisoner's dilemma" instinct to defect in the absence of information on other shareholders' strategies). "Takeovers a la carte," Economist, December 21, 1991, p. 11. It may also broaden the corporate constituency beyond shareholders to include employees and suppliers, forcing management to include their interests when considering a bid.
64. "Poison pill" is a generic term that describes any provision in a company's articles of association that is triggered by a takeover attempt and is intended to make the target company less attractive. Such provisions may offer better redundancy terms for employees, put its pension funds under independent management, or otherwise prevent the bidding company from making the profit it had hoped. If takeovers benefit shareholders, poison pills harm them, because they reduce the value of the company to bidders. On the other hand, poison pills have also been interpreted as formalizing previously implicit contracts between managers and various stakeholders in a firm. Under this interpretation, they can benefit shareholders by helping to preserve long-term stability. See A. Schleifer and L. Summers, "Breach of Trust in Hostile Takeovers," in A. Auerbach, ed., Corporate Takeovers: Causes and Consequences, Chicago U. Press, 1991.
65. As of 1989, twenty years after takeover rules were introduced, there had only been two takeover bids in Japan. "Japan to Relax Rules on Takeovers," Financial Times, November 6, 1989, p. 43.
66. "Mergers and Acquisitions in Japan: Lifting a Barrier or Two," Economist, Aug. 12, 1989, p. 68.
67. "'Hijacking' Now Respectable in Japan," Financial Times, January 18, 1990, p. 43.

reduced turnover in the stock market generally; and second, powerful bank holdings and proxy voting strength have dissuaded investors from seeking control. Also, Germany was known for having the toughest anti-takeover devices in all of Europe.⁶⁸ The picture may now be changing slightly, as German takeovers appear to be on the rise.

Takeover mechanisms remain largely untested in CEE, although their importance may grow with privatization. Indeed, promoting competition in the privatization process itself is analogous in many ways to allowing an unfettered takeover market, in that the right of corporate ownership and management is allowed to gravitate to those who believe they can manage most efficiently and effectively. The allocation of decision making authority and the availability of legal defenses against takeovers are both likely to be difficult issues. On the one hand, mergers and acquisitions may be highly desirable in this environment given the extent of inefficiency in current industrial structure and management, and giving greater authority to shareholders while minimizing a firm's legal defenses will help minimize insider opposition to such transactions. On the other hand, giving shareholders extensive decision making authority may be futile or even counterproductive if they are themselves unorganized or uninformed and if the stock market is relatively illiquid.

Conclusions

Patterns of corporate ownership and governance in advanced market economies vary immensely, the result not only of policy choice but also of cultural and political differences and historical accident. None of those patterns can be copied wholesale onto the Central and Eastern European scene. However, the experiences of the United States, Germany, and Japan do point to certain lessons and tradeoffs that the CEE countries should consider.

First, there is probably some tradeoff between wealth distribution and the efficacy of corporate governance in an economy. Theory and to some extent practice support the view that tighter ownership patterns lead to better corporate performance. However, more widely disbursed ownership patterns clearly have other economic and social benefits that are important in the CEE context and to some extent (along with speed) motivate the "mass privatization" plans. The use of institutional intermediaries and creative legal frameworks to concentrate voice more than ownership may be a partial solution to the dilemma. Stronger and more committed voice might also be gained by encouraging ownership by parties with other long-term contractual interests, whether as suppliers, employees, or creditors.

Second, there is likely to be some tradeoff between industrial structure and the efficacy of corporate governance. Given a certain distribution of ownership in an economy, smaller firms mean fewer owners, greater stakes per owner, and thus greater incentives and lower costs for shareholder monitoring. Yet CEE industrial structure tends to be highly

68. "Europe's Corporate Castles Begin to Crack," Economist, November 30, 1991, p. 67.

concentrated. Although there may other benefits to preserving such concentration in some industries, antimonopoly and privatization policies should not leave the governance issue out of the equation.

Finally, there is clearly an important tradeoff between the efficacy of corporate governance and concerns of safety and soundness in financial intermediaries. The United States represents one extreme, where concerns of safety and soundness dominate, virtually eliminating active participation by banks, insurance companies, pension funds, and mutual funds in corporate governance. Germany and Japan are on the other side (although perhaps not to such an extreme), allowing financial intermediaries (and other related firms) a major voice in corporate governance. Unfortunately, this tradeoff is even more difficult in Central and Eastern Europe because of the lack of alternative tools to achieve either goal. On the one hand, legal and information systems are relatively weak, making it difficult to identify and eliminate irresponsible self-dealing by fiduciaries in the intermediary institutions. Furthermore, the high degree of risk in these economies argues strongly in favor of diversification on safety and soundness grounds. On the other hand, product, capital, and labor markets are often under-developed, and thus there may be few other constraints to discipline company managers in the absence of active shareholder monitoring. On balance, the CEE countries would arguably be wise to err on the side of stronger corporate governance--more along German or Japanese than along U.S. models.

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